Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
of the Securities Industry and Financial Markets Association
October 30, 2007

The Committee convened in closed session at the Hay-Adams Hotel at 10:30 a.m. All Committee members except Gary Cohn were present. Assistant Secretary for Financial Markets Anthony Ryan, Deputy Assistant Secretary for Federal Finance Matthew Abbott, and Office of Debt Management Director Karthik Ramanathan welcomed the Committee and gave them the charge.

The Committee addressed the first item in the Committee charge (attached) regarding debt issuance in light of intermediate and longer-term fiscal trends. Director Ramanathan presented a series of charts related to the fiscal situation, and noted some current trends, including positive but slower revenue growth, reduced growth in outlays, and increased volatility in State and Local Government Securities (non-marketable debt) issuance. The charts also highlighted the recent volatility in Treasury cash balances as well as recent data outlining net purchases of Treasury securities by international investors.

Several themes related to the short end of the Treasury market and credit markets as a whole also emerged from the charts. While credit conditions have improved since summer, Director Ramanathan noted that Treasury needs to be cognizant of the potential challenges to economic growth as well as their implications on debt issuance. Given that, on average, deficit estimates can vary by nearly $100 billion in either direction twelve months in advance of the end of the fiscal year, debt managers need to maintain flexibility. In addition, shifts in revenues and outlays in FY 2008 may be less gradual than expected, and may necessitate increased reliance on bills from current, relatively low issuance levels.

In addition, Director Ramanathan reiterated his prior comments that Treasury continues to consider the four-week bill as a cash management tool which may be subject to greater variations in issuance when compared to other Treasury securities. Given the potential for adjustments to the economic outlook, such variations in bill issuance will continue in the future. Nonetheless, the volatility of issuance has not significantly differed versus prior years. While market participants encountered increased uncertainty in the bill sector this past summer, the actual volatility of issuance in the sector overall remains fairly stable. For example, one measure of relative volatility, the coefficient of variance of issuance for the four-week bill, has moved marginally to 34% in FY2007 from 33% at the end of FY2006, implying fairly consistent issuance patterns.

Following this discussion, Director Ramanathan focused on recent events in short-term credit markets, including volatility in money market rates such as LIBOR, commercial paper, asset backed commercial paper, and Treasury bills. The flight to quality in August 2007 as a result of credit events both domestically and in Europe benefited Treasury from the perspective of increased issuance of securities at low interest rates.

However, the large variations in rates and persistent demand for shorter dated securities – particularly in the Treasury bill market – were unprecedented, according to Director Ramanathan. As a result, the appetite for risk temporarily diminished, and in the process, impacted Treasury auctions. Market participants and investors perceived the auctions in August (including the four-week bill which tailed over 200 basis points) as anomalies. Moreover, these auction results did not warrant adjustments by Treasury, be it earlier auction times or adjustments to the auction calendar. In addition, auctions since August have been performed well, suggesting that the auctions in August may have precipitated the repricing of risk to more rational levels.

Nonetheless, Director Ramanathan stated that the auctions in August drew the attention of Treasury, and led to an evaluation of the situation in short-term credit markets and the root causes of this flight to quality.

In conclusion, the charts noted that Treasury faces uncertainty given the fiscal and economic outlook, and that flexibility is critical to managing potential borrowing scenarios. According to Director Ramanathan, Treasury could raise over $200 billion with relative ease if necessary given the low level of bills outstanding and reduced coupon issuance sizes. Financing decisions will continue to be made in a transparent manner and in consultation with market participants.

The Committee began the discussion of the first charge with one member noting that events in the short-end of the market this summer were related to supply and demand imbalances exacerbated by an extreme movement out of commercial paper into risk-free Treasuries. As short rates richened, demand declined temporarily, and the market readjusted accordingly. Another member noted that credit markets faced the "perfect storm" in August and that all asset classes were impacted. This member noted that the flight to quality to Treasuries once again showed the importance of the Treasury market on a global basis.

The Committee then turned to the issue of how Treasury should proceed with adjustments to borrowing over the next fiscal year in light of recent intermediate to long-term fiscal trends. Deputy Secretary Abbott asked if the current auction calendar was sufficient to confront potential downside and upside variations to the deficit forecast. The Committee noted that over the last few years, the deficit has improved as receipts increased substantially while outlays grew at a slower than expected rate. The Treasury has managed the reduced borrowing need by reducing bill issuance along with coupon sizes. One member noted that there may be some risk to a higher than expected deficit given the potential for the growth in receipts to fall, the pace of outlays to increase in 2008 from current moderate levels, and the reversion of SLGS issuance to more normal levels from near record net issuance in FY2007,. In that case, the Committee recommended that Treasury address any upside surprise in funding needs mainly through increases in bill issuance and shorter dated securities.

One member noted that the market could easily absorb another $100 billion in bill issuance if it occurred gradually. Another member noted that bills as a percent of Treasuries outstanding were near 10-year lows and there was plenty of capacity to increase issuance. The member further noted that capacity was not the issue in the bill market provided that Treasury continues to be transparent about its issuance decisions. A few other members noted that there was a renewed appetite for risk-free credit assets, and that issuing more bills in this environment may benefit the market as a whole.

Another member asked if the risk to the deficit was asymmetric, i.e., could the deficit improve in FY 2008 if Congress and the President remain in deadlock over spending. A member stated in response that even if the pace of spending slows, revenue growth could fall even further which would lead to increased borrowing needs. Another member agreed and stated that the likelihood of a positive surprise remained low. However, the Committee acknowledged that risk needed to be considered and could be addressed through reductions in the bill sector or other means if necessary.

The Committee then addressed recent market dislocations in short term credit markets and their relationship, if any, with Treasury markets. A Committee member was asked to address this item and presented a series of slides showing that securitization has been beneficial to investors, generally offering higher yield spreads and diversification, while helping disperse throughout the global financial system risks that were once concentrated in a handful of large banks. However, according to the presenting Committee member, the recent developments stemming from trouble in the sub-prime mortgage market illustrate some of the potential threats of structured finance.

According to the presenting Committee member, securitization offers many benefits, but because it disperses risk so widely, the process has made it harder to pinpoint where the risks reside and how investors may behave in times of market stress. Domestic sub-prime mortgage loans were marketed to investors in the form of asset-backed securities (ABS), which bundle together multiple subprime home loans. Some of the riskiest tranches of these ABS were subsequently resecuritized into CDOs, further increasing their complexity. Complex investments like structured investment vehicles purchased some securitized products, and were unable to roll over their asset backed commercial paper (ABCP) financing when markets seized this summer.

The presenting Committee member stated that ratings agencies have exacerbated the problem by giving investors a sense of comfort through ratings that have in many cases proven to be flawed. According to the presenting member, agencies should be encouraged to address conflicts of interest, perhaps by correlating payment for services to the long-term stability of ratings, or by asking issuers to prepay in full for ratings and disclose such ratings to all market participants.

The presenter concluded that more regulation to securitization is not the answer to resolving the problems in the capital markets, although lenders should be reminded of the moral hazards of short-term lending against long-term assets. A reevaluation of "truth in lending" may be needed in the mortgage banking business, which lacks the fiduciary culture that exists in the investment banking and broader financial industry.

In the discussion that followed the presentation, the Committee began by noting the reputation of securitization has been tainted by a small portion of the assets that are securitized – i.e. the majority of the assets underlying ABS are considered high quality, and the small minority of poor assets has effectively “contaminated” the whole sector. A larger problem is the lack of transparency regarding the credit quality of these underlying assets and other structured finance products. Another member agreed with this perspective, and added that models used by the rating agencies may be flawed in terms of data quality and economic assumptions; moreover, rating agencies may even have a conflict of interest in the rating process since the originator of the product they are rating is effectively “paying” for the rating.

Another member noted that structured financial products tend to “become fatal when they get sick” unlike traditional diversified investments. This member noted that the risk distribution in structured products does not follow a traditional bell shaped, normal distribution, but instead is characterized by a distribution with “fat tails”.

One member, noting the status of the rating agencies and how the rating agencies potentially mishandled recent events, rhetorically suggested that ratings agencies may need to reconsider their private status. The member indicated that the analysis of credit risk on an independent basis was difficult because data needed to adequately assess risk was often only available to ratings agencies. The time and effort to do this analysis was also prohibitive for some investors.

Another member noted that risk was in the process of being repriced, and it would probably take another six months to a year for this to occur. As a result, liquidity and volatility in these markets will be impacted. The discussion then turned to the structure proposed by the private sector in relation to the ABCP market. Assistant Secretary Ryan gave a brief overview of the proposed structure, and Treasury’s role in facilitating the development of this private sector initiative. The proposed structure, as well as the many other alternative structures being considered in the market at this time, may potentially preclude a low probability/ high impact event by providing backstop liquidity to the ABCP market. A private sector initiative that was designed to bring about orderliness to the repricing of risk and that could help in the price discovery process could potentially be useful.

Most Committee members agreed that an orderly unwind of these assets was a positive outcome given the alternative scenario. Some Committee members opined that the orderliness to the risk-repricing that the proposed structure was designed to achieve may delay the repricing of risk. Another member stated that, slowing the repricing of risk was not the issue that would settle markets; instead, more transparency into the structured transactions is what was needed before liquidity would return. .Another member added that given that economics would influence the participation or lack thereof of liquidity providers, and that participation by end users also appeared to be voluntary, such a proposal would complement other responses being implemented in capital markets currently. Two members then concluded the discussion of the structure stating that the private sector initiative would be better evaluated when more details of the proposal were released.

In terms of the implications for the Treasury market, the Committee members generally felt that the events would enhance demand for Treasury securities. They noted that because many investors do not have the time or expertise to do risk analysis on their own for complicated structured products and because the rating agencies were having difficulty in establishing ratings in which investors have confidence, more market participants and traditional ABS buyers may shift into Treasury or agency products in the coming year.

Finally, the Committee was asked about their thoughts regarding current and future demand for Treasury securities. A Committee member presented a series of slides linking the current account deficit to strong demand for Treasury securities from foreign investors which has funded the federal deficit. Demand has not only come from the official sector but also private investors. The presenting member stated that structural factors - not market dynamics - have created demand for Treasuries from oil producing countries and Asian economies which trade with United States. Central banks and sovereign wealth funds have marginally diversified out of the dollar, but private investors continue to be net buyers of Treasuries.

The presenting member noted that one month of data may not indicate a change in trend, and given the slope of the demand curve over the past four years, a pullback was to be expected. Moreover, the presenting member noted that emerging nations, many not fully captured in publicly available data, remain strong buyers of US Treasuries in one form or another. These purchasers may believe that large foreign exchange reserves create increased stability in times of stress. The presenting member concluded by stating a number of factors needed to be evaluated to determine future Treasury demand including international currency policy, foreign exchange reserve accumulation, private sector flows, the global economic outlook, geopolitical issues, pension fund demand, and potential entitlement changes.

Committee members generally agreed with the presenting Committee member. One member noted that recent stresses in the credit market may precipitate further buying of Treasuries in the future. Another member noted that the composition of buyers in foreign jurisdictions such as the United Kingdom and the Caribbean may encompass many other nations or types of investors.

A Committee member asked why Treasury thought investors remained so committed to the domestic markets. Director Ramanathan stated that, in general, major investors and reserve managers prefer the liquidity, the transparency, and the depth of the US Treasury market, and preserving these fundamental characteristics was critical to ensuring continued demand in the future.

The Committee then reviewed the financing for the remainder of the October through December quarter and the January through March quarter.

The meeting adjourned at 12:08 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:00 p.m. All the Committee members except Gary Cohn were present. The Chairman presented the Committee report to Assistant Secretary Ryan. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:15 p.m.

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Karthik Ramanathan
Director
Office of Debt Management
October 30, 2007

Certified by:

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Keith T. Anderson, Chairman
Treasury Borrowing Advisory Committee
of The Securities Industry and Financial Markets Association
October 30, 2007

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – October 30, 2007

Fiscal Outlook

In light of intermediate and longer-term fiscal trends as well as recent economic and market conditions, what advice would the Committee give in terms of Treasury's debt issuance?

Securitization, Rating Agencies and the Money Markets

What are the Committee's views regarding recent market dislocations in short term credit markets and their relationship, if any, with Treasury markets?

Treasury Market Dynamics

What are the Committee's thoughts regarding current and future demand for Treasury securities?

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes and bonds to refund approximately $51.5 billion of privately held securities maturing or callable on November 15, 2007.

- The composition of Treasury marketable financing for the remainder of the October-December quarter, including cash management bills.

- The composition of Treasury marketable financing for the January-March quarter.